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Nos. 84-184, 84-185 and 84-186

In the Supreme Court of the United States

OCTOBER TERM, 1984

WILLIAMS PIPE LINE COMPANY, PETITIONER

v.

FARMERS UNION CENTRAL EXCHANGE, INC., ET AL.

TEXAS EASTERN TRANSMISSION CORPORATION, PETITIONER

v.

FARMERS UNION CENTRAL EXCHANGE, INC., ET AL.

ASSOCIATION OF OIL PIPE LINES, PETITIONER

v.

FARMERS UNION CENTRAL EXCHANGE, INC., ET AL.

ON PETITIONS FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether the court of appeals properly determined that the ratemaking methodology selected by the Federal Energy Regulatory Commission for regulation of oil pipeline rates does not comport with the just and reasonable standard of 49 U.S.C. (1976 ed.) 1(5) and was not supported by a reasoned explanation.

2. Whether petitioner Williams Pipe Line Company was afforded an adequate opportunity to be heard before the Commission decided a generic issue that also substantially affected Williams' interests (No. 84-184).

3. Whether the court of appeals properly upheld the Commission's decision on an aspect of one of two methodologies permited by the Commission for computing the tax component of rates (No. 84-186).

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A92) is reported at 734 F.2d 1486. The opinion of the Federal Energy Regulatory Commission (Pet. App. B1-B342) is reported at 21 F.E.R.C. ¶ 61,260.

JURISDICTION

The judgment of the court of appeals (Pet. App. C1-C4) was entered on March 9, 1984. Petitions for rehearing were denied on May 4, 1984 (Pet. App. D1-D2). The petitions for a writ of certiorari were filed on August 2, 1984. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

The pertinent provisions of the Administrative Procedure Act, 5 U.S.C. 706, and the Interstate Commerce Act, 49 U.S.C. (1976 ed.) 1 *et seq.*, are set forth at Pet. App. E3-E4.

STATEMENT

1. *Background*

In 1972, respondent Farmers Union Central Exchange and other shippers challenged as unreasonably high certain increased rates filed with the Interstate Commerce Commission (ICC) by petitioner Williams Pipe Line Company (Williams). After a hearing, the ICC found the rates lawful, relying on a "valuation" rate base methodology and "guideline" rates of return adopted in a trilogy of oil pipeline rate cases in the early 1940's.[1] *Petroleum Products, Williams Bros. Pipe Line Co.*, 355 I.C.C. 479, 483-488 (1976), aff'g 351 I.C.C. 102 (1975).

While review of the ICC decision was pending in the court of appeals, Congress transferred jurisdiction to regulate oil pipeline rates from the ICC to the newly formed Federal Energy Regulatory Commission (FERC). See 42 U.S.C. 7172(b). FERC refused to defend the ICC decision, moving instead for a remand of the case to it.

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[1] *Minnelusa Oil Corp.* v. *Continental Pipe Line Co.*, 258 I.C.C. 41, 49-51, 64 (1944); *Petroleum Rail Shippers' Ass'n* v. *Alton & S.R.R.*, 243 I.C.C. 589, 662-663 (1941); *Reduced Pipe Line Rates & Gathering Charges*, 243 I.C.C. 115 (1940), reopened, 272 I.C.C. 375 (1948).

After the case had been fully briefed and argued on the merits (with the ICC and Williams defending the order), the court of appeals granted FERC's remand motion. *Farmers Union Central Exchange* v. *FERC*, 584 F.2d 408 (D.C. Cir.), cert. denied *sub nom. Williams Pipe Line Co.* v. *FERC*, 439 U.S. 995 (1978) (*Farmers Union I*). Although it expressed "unease with the ICC's findings regarding rate base, rate of return, and depreciation costs" (584 F.2d at 421),[2] what "clinche[d]" the court's decision to remand was that "FERC[] has requested a remand so that it may begin its regulatory duties in this area with a clean slate" (*ibid.*). The purpose for the remand was "to allow the relevant administrative agency to attempt for itself to build a viable modern precedent for use in future cases that not only reaches the right result, but does so by way of ratemaking criteria free of the problems that appear to exist in the ICC's approach" (*ibid.*).

On remand, FERC assigned this case to an administrative law judge (ALJ), who separated the proceeding into two phases: Phase I to consider the ratemaking methodology to be applied to the oil pipeline industry, and Phase II to apply those principles to the specific facts of this case. The Department of Justice, petitioner Association of Oil Pipelines (AOPL), and various individual pipelines (including petitioner Texas Eastern Transmission Corp.) then intervened, and a lengthy hearing ensued. After the hearing, FERC ordered the record to be certi-

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[2] The court of appeals in *Farmers Union I* rejected the argument that the fair value ratemaking methodology is legally required by the Valuation Act, 49 U.S.C. (1976 ed.) 19a (584 F.2d at 413 n.8). Moreover, it found that the indicia cited by the ICC in support of that methodology are "products of a bygone era of ratemaking ushered in by the Supreme Court in *Smyth* v. *Ames* [169 U.S. 466] in 1898 and ushered out by that same body in [*FPC* v.] *Hope Natural Gas* [*Co.*, 320 U.S. 591] in 1944," and observed that it was "not persuaded by the Commission's conclusion that 'consistency and fairness' dictate resurrection of the 'fair value' method last used thirty years ago" (584 F.2d at 418).

fied directly to it, without an initial decision. On November 30, 1982, it issued the decision under review in this case (Pet. App. B1-B342).

2. ***The FERC Decision***

Noting that its statutory mandate is to determine "just and reasonable" rates, FERC concluded that the meaning of that phrase may differ depending on the regulatory context (Pet. App. B101, B119). Reviewing the legislative history of the Hepburn Act, ch. 3591, 34 Stat. 584 *et seq.*, which brought oil pipelines under the ICC's jurisdiction, FERC found that the statute was designed exclusively to end the "prohibitive" pricing tactics of the Standard Oil Company, which had used its monopoly on oil pipelines to control the refining industry (Pet. App. B125-B127). FERC concluded (*id.* at B128; footnote omitted):

> [W]e discern no intent to limit these carriers' rates to barebones cost. What we perceive is an effort to restrain gross overreaching and unconscionable gouging.

In addition, FERC found that, due to competition, "[p]rohibitive pricing was consigned to antiquarians long before OPEC and the post-1973 advance in oil prices" (*id.* at B160), and that the consumer benefit from stricter rate regulation would be "submicroscopic" (*id.* at B177). On the other hand, it found that the chief policy concern now was to preserve the incentive for investment and to avoid disinvestment in oil pipelines (*id.* at B129 n.208, B178-B179, B207, B274). For these reasons, FERC concluded that "it does seem best to err on the side of liberality" (*id.* at B177), and that regulation should be imposed only "in cases of egregious exploitation and gross abuse" (*id.* at B284).

In applying these standards to this case, FERC opted to continue the existing ICC valuation methodology, which derived a rate base through an arbitrary formula that averaged original cost and estimated reproduction

cost (Pet. App. B180 n.295; see *id.* at A18 n.28). In so doing, it recognized that original cost accounting principles are universally used by businesses, including those in the oil pipeline industry, for their own accounting purposes (*id.* at B188-B190), and that use of such an approach in calculating rate base is "easy" and "logical" (*id.* at B193). FERC also recognized that the ICC's valuation methodology was not a system of "rigorous logic and Euclidean consistency," and stated that it might not have adopted that methodology "[w]ere we beginning afresh on a clean slate," nor continued it, with its "anomalies and inconsistencies," "[w]ere we dealing with matters of vital import to the consumer" (*id.* at B184, B228). Nevertheless, FERC reasoned that "a rate base that might flunk an examination in logic is usable provided that the combination of a rate base and rate of return provides a socially acceptable end result" (*id.* at B185). It stated a number of reasons for finding the "end result" of the valuation methodology to be "socially acceptable." First, FERC wished to consider the benefit to the buyer, or "value of service," in setting rates (*id.* at B192 & n.319). Second, it considered the "public utility" model of regulation unsuitable because it doubted that it could determine the industry's true cost of capital (*id.* at B193-B202) and feared that, even if it could, application of ordinary public utility style risk analysis would result in such low returns that "incentives for oil pipeline investment would decline" (*id.* at B212; see *id.* at B202-B212). Third, "drastic conceptual changes" would be "disruptive" and "frustrate entrepreneurial expectations that we deem rational, legitimate, and worthy of respect" (*id.* at B228 n.373; see *id.* at B213-B216). Fourth, a strict original cost methodology induces high rates early in the life of an asset, tapering off as the asset is depreciated — the so-called "front-end load." FERC reasoned that the more level rates attributable to a valuation methodology would facilitate competitive entry (*id.* at B218-B229), although it conceded that "simpler and more logical" rate base policies could be de-

vised that would alleviate the front-end load problem (*id.* at B228).[3]

To complement the valuation rate base, FERC adopted a tripartite rate of return composed of actual debt service costs, a "suretyship premium" to compensate the pipelines' parent companies for any material guarantees they may have given to pipeline bondholders, and "a *'real'* entrepreneurial rate of return on the equity component of the valuation rate base" (Pet. App. B271-B272; emphasis in original). In normal economic parlance, a "real" rate of return is one that is reduced by the amount of expected future inflation; under FERC's formula, a "real" rate of return was to be derived by reducing a nominal or market rate of return by the percentage increase in the valuation rate base over the period for which the nominal rate was selected. The "entrepreneurial" rates were to be "appreciably higher than those the Commission awards to natural gas pipelines and to wholesalers of electric energy" (*id.* at B274; footnote omitted). Normally a pipeline would be allowed to choose the most favorable from a list of potential rates of return set forth in the Commission's opinion, including returns in the oil industry generally and the non-pipeline investments of the parent company of the particular pipeline (*id.* at B274-B275). The "equity component of the valuation rate base" was defined to include the entire current valuation, less only the face amount of any remaining debt, so that the equity holders would receive the full benefit of inflation in the portion of the rate base originally paid for with debt capital (*id.* at B280-B285). In

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[3] The Commission did make some changes in the ICC valuation rate base. Specifically, it excluded the value of leased property from the rate base (Pet. App. B233 n.386). It also determined that the ICC's working capital formula would be granted only a weak rebuttable presumption of validity; it could be challenged on a case by case basis (*id.* at B233-B234 n.386).

On the other hand, FERC declined to change the ICC's policy of permitting pipelines to claim depreciation as a cost of service on a straight line basis while a "condition percent" methodology is used in computing rate base depreciation (Pet. App. B231-B233). Al-

light of its belief that actual and potential competition in the oil pipeline industry could generally be relied on to restrain rates, FERC's stated objective in adopting its rate of return formula was to "set[] ceilings that we assume will seldom be reached in actual practice" (*id.* at B283).[4]

3. *The Court of Appeals' Decision*

The court of appeals remanded the case to FERC for further proceedings (Pet. App. A1-A92). The court recognized that under the judicial review provisions of the Administrative Procedure Act, 5 U.S.C. 706(2)(A), a reviewing court must carefully scrutinize the agency decision to ascertain whether it is "'reasoned' in light of the record" and "true to the congressional mandate from which [the agency] derives authority," but that the court is "not at liberty to substitute [its] judgment in the place of the agency's" (Pet. App. A28). The court concluded (*id.* at A7), however, that

> the Commission's order contravenes its statutory responsibility to ensure that oil pipeline rates are "just and reasonable." In addition, we hold that FERC failed both to give due consideration to responsible alternative rate-making methodologies proposed during its administrative proceedings, and to offer a reasoned explanation in support of its own chosen ratemaking methodology, and that therefore the FERC order constitutes impermissible "arbitrary and capricious" agency action.

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though it acknowledged that this "mismatch" was "anomalous," it said that it would "ponder * * * on another day" whether the cost of correcting it was worthwhile (*id.* at B233).

[4] Commissioners Sheldon and Richard filed individual concurring opinions (Pet. App. B314-B319; *id.* at B340-B342).

Commissioner Hughes dissented in part, concluding that the valuation formula, "[r]ooted in obscurity * * * has no logical basis shown of record nor does the majority Opinion herein make any rational explanation of it in their mystifying attempt to perpetuate a decaying form of arcane, regulatory lore" (Pet. App. B322). He similarly characterized the Commission's rate of return formula as "the regulatory equivalent of 'Dialing for Dollars'" (*id.* at B332 n.4).

a. The court of appeals noted that under the statutory "just and reasonable" standard, FERC is free to set rates within a "zone of reasonableness" (Pet. App. A30-A32). It also noted that FERC is not rigidly bound to a cost-based regime (*id.* at A30), but pointed out (*id.* at A33) that

> [b]ecause the relevant costs, including the cost of capital, often offer the principal points of reference for whether the resulting rate is "less than compensatory" or "excessive," the most useful and reliable starting point for rate regulation is an inquiry into costs. * * * At the same time, non-cost factors may legitimate a departure from a rigid cost-based approach. * * * The mere invocation of a non-cost factor, however, does not alleviate a reviewing court of its duty to assure itself that the Commission has given reasoned consideration to each of the pertinent factors. * * * Thus, when FERC chooses to refer to non-cost factors in ratesetting, it must specify the nature of the relevant non-cost factor and offer a reasoned explanation of how the factor justifies the resulting rates.

Reviewing FERC's rationale, the court found that the agency had failed to provide a reasoned basis for its decision that was consistent with its statutory mandate (Pet. App. A33-A50). First, the court held that the statute forbids all abusive rates, not only those that constitute "gross abuse" (*id.* at A33). Although the agency had cited the non-cost factor of the need to stimulate new pipeline construction as a reason for setting maximum rates at such high levels, the court pointed out that FERC had not quantified the need for additional capacity "and did not even attempt to calibrate the relationship between increased rates and the attraction of new capital" (*id.* at A34). Nor was FERC's liberal standard mandated by the statute. After examining the legislative history of the Hepburn Act (*id.* at A36-A42), the court concluded that Congress intended to impose the same standard of rate regulation on oil pipelines as on other common carriers such as railroads, and also intended to

limit oil pipelines to a "fair return," rather than eliminating the specific abuse of "prohibitive pricing" (*id.* at A37). Finally, the court found that the Commission erred in relying on changes in the oil pipeline industry since 1906 as justifying "its novel interpretation of its statutory responsibilities under the Interstate Commerce Act" (*id.* at A42). First, the court noted that the fact that the cost of transportation has become a small and relatively insignificant part of the total price of a barrel of oil did not excuse FERC from its obligation to regulate rates under the statute in a meaningful way (*id.* at A43-A44). Second, the court stated that the Commission had failed to justify its reliance on market forces to ensure reasonable rates (*id.* at A44-A50), particularly in light of FERC's admission that competition is not " 'omnipresent,' " the agency's dismissal of the "extensive record" on the issue as " 'beside the point' " (*id.* at A45 n.50), and the "extraordinarily high" regulatory ceilings it set (*id.* at A49).[5] The court explained (*id.* at A48):

> FERC's methodology, by its own admission, merely sets "ceilings seldom reached in actual practice," and permits "creamy returns" to oil pipelines. As we have explained above, such ratemaking does not comport with FERC's statutory responsibilities. FERC's methodology, therefore, exposes a range of permissible prices that would exceed the "zone of reasonableness" by definition, unless competition in the oil pipeline market drives the actual prices back down into the zone. But nothing in the regulatory scheme itself acts as a monitor to see if this occurs or to check rates if it does not. That is the fundamental flaw in the Commission's scheme.

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[5] The court of appeals found it especially unlikely that Congress intended rates covered by the Hepburn Act to be effectively deregulated when, in a railroad deregulation provision, 49 U.S.C. 10709, Congress required particularized findings on market dominance with respect to each railroad service challenged (Pet. App. A45-A46 n.50).

b. In addition, the court of appeals held, "[a]s independent grounds for our decision today" (Pet. App. A50), that FERC had failed to reach a reasoned decision based upon consideration of all the relevant factors (*id.* at A50-A86).

Considering the rate base issue first, the court of appeals noted the advantages of original cost and the flaws of the valuation methodology set forth in the record and conceded by FERC. Observing that "significant and viable" alternatives to the ICC valuation formula were "fully discussed during the *Williams* proceeding" (Pet. App. A51 n.54), the court held that the agency "has a duty to consider responsible alternatives to its chosen policy and to give a reasoned explanation for its rejection of such alternatives" (*id.* at A51-A52; footnote omitted). It then reviewed individually the reasons given by FERC for retaining the valuation rate base. First, it found that FERC's rejection of original cost, on the ground that determining the real cost of capital for the highly leveraged pipelines would be too difficult, was inconsistent with its decision to allow a "suretyship premium" in conjunction with its valuation methodology—an approach that required exactly the same economic analysis as the traditional original cost technique of constructing a hypothetical capital structure (*id.* at A55-A58). Moreover, the court noted that a suretyship premium approach seemed equally suited to an original cost methodology, and that the agency had provided no reason why its preference for a suretyship premium should also have led it to favor a valuation rate base (*id.* at A58-A59). Second, after reciting a "sampling from a long list of witnesses" who had testified on behalf of pipelines regarding the relationship between risk and pipeline investment (*id.* at A61 n.63), the court found "no basis to support, and overwhelming evidence to contradict, FERC's finding that comparable risk analysis has no important role in oil pipeline rate regulation" (*id.* at A63). Third, the court rejected FERC's reference to the "front-end load"

aspect of original cost methodology, on the basis of FERC's own admission that a " 'simpler and more logical' " inflation-sensitive rate base policy, such as trended original cost, was available (*id.* at A63-A64). Fourth, the court found that FERC had failed to show that the transition to a more logical methodology would be any more formidable or costly than continuation of the valuation methodology — indeed, it found no reasoned basis even for FERC's assumption that transitional rate bases would be needed (*id.* at A65-A67). In addition, the court found that FERC's apparent deference to the pipelines' expectations of large profits, as well as the agency's reliance on its prior conclusion that strict regulation was unnecessary, were not permissible considerations under the statute (*id.* at A66-A67 & n.65). Finally, the court emphasized that its holding "does not go to the wisdom or efficacy of the ICC rate base formula * * *. Rather, our decision here turns on the inadequacies manifest in the decision-making process followed by FERC" (*id.* at A71-A72; footnote omitted).[6]

Turning to FERC's "entrepreneurial rate of return" formula (Pet. App. A73-A75), the court of appeals concluded (*id.* at A75-A76):

> We frankly cannot locate the rhyme nor reason of this rate of return methodology; nor is it based upon a consideration of all relevant factors in oil pipeline ratemaking. To begin with, FERC offered no rational explanation that linked its regulatory purposes with its chosen rate of return indices. * * * As a result, the total returns allowable under FERC's methodology have no discernible regulatory significance beyond the fact that they are bound to be very large. FERC does not even offer an explanation of why its ratemaking formula sets "a cap of gross abuse," let alone a just and reasonable rate.

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[6] The court of appeals also held that FERC had failed to provide an adequate explanation for rejecting certain improvements to the valuation rate base proposed by petitioner AOPL (Pet. App. A67-A71). That ruling has not been challenged in this Court.

The court then examined in detail three elements of the Commission's formula. First, it found that "FERC offered no reason to believe that the risks associated with the unregulated enterprises from which it derived its rates of return were equivalent to the risks of running an oil pipeline," and that "FERC never established a reasonable connection between its stated purpose to preserve the financial integrity and economic viability of oil pipelines and its selected rate of return indices" (*id.* at A76-A77; footnote omitted). In this connection, the court observed that there is a substantial question "whether FERC's selected indices grossly *overestimate* the risks and needed returns prevailing in the oil pipeline business" (*id.* at A78; emphasis in original). Second, although FERC deducted any inflation adjustment to the rate base from the current allowable rate of return for the period from which the rate of return was selected (*id.* at A80), its approach still allowed the pipelines to retain the full benefit of earlier aggregate rate base write-ups (*id.* at A80-A81). Moreover, because the FERC rate of return indices allowed the pipelines a choice each year among time periods as well as types of investments, and the pipeline valuation increases do not track general inflation indices closely, the formula provided yet another area for pipeline manipulation of their returns (*id.* at A81). Third, by allowing a return on the current valuation of the pipelines less the face amount of their debt while using as comparables returns measured as percentages of the book equity of other firms, "FERC's method ensures that the allowable revenues for oil pipelines will *exceed* the revenues earned by its selected unregulated companies by the extent to which the pipelines' 'equity component' exceeds the portion of the rate base financed through equity investments. * * * In most cases, this difference will be very large" (*id.* at A83; footnote omitted; emphasis in original). "[S]uch a ratemaking methodology * * * assures nothing except that permissible rate levels will be

very high" and "has no significant relationship with the determination of the cost of capital" (*id.* at A84). Thus, while recognizing the agency's broad discretion to select a ratemaking methodology, and without precluding the use of a valuation rate base (*id.* at A85), the court concluded that the particular combination of rate base and rate of return methodologies adopted by FERC in this case "does not produce an acceptable 'end result' " (*id.* at A86).[7]

In defining the scope of the remand, the court of appeals specifically permitted FERC to take additional evidence, but it reiterated the statutory mandate that oil pipeline rates must be set within the "zone of reasonableness," that departures from cost-based rate principles must be identified and justified, that allowable rates of return must take risk into account, and that rate base and rate of return must be carefully integrated "to produce a just and reasonable rate" (Pet. App. A92). The court carefully refrained from ordering FERC to adopt an original cost methodology, although it noted that such a methodology was "a proven alternative" and that "FERC should reexamine this alternative, and others" (*ibid.*).

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[7] In addition, the court of appeals took note of a number of other "features of the ICC rate base formula" that "have led experts to call it 'nothing less than bizarre; it is a mysterious collection of seemingly unrelated components that, through the wonders of jurists' algebra, miraculously distill into a single sum' " (Pet. App. A71-A72 n.68). Among these "bizarre" features are FERC's retention of a mismatch between the "method of depreciation used to determine the cost of service expense and the 'condition percent' method used to determine depreciation for rate base purposes," and the use in the rate base of "reproduction cost" new (the current cost of reproducing the pipeline's identical facilities), rather than "replacement cost" (the cost of building a pipeline with the same function and capacity, but reflecting improved material and technology) (*ibid.*).

ARGUMENT

It is the position of the United States that the decision of the court of appeals, remanding this case to the Commission, is correct, does not conflict with any decision of this Court or of any other court of appeals, and does not warrant review.[8]

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[8] The Commission, which defended its decision before the court of appeals, adheres to the position that its decision is correct but takes no position with respect to whether certiorari should be granted on the principal question presented. The Commission agrees with the United States that the additional issues raised by petitioners Williams and AOPL, as to which the Commission prevailed in the court of appeals, do not warrant review.

Williams seeks review of the court of appeals' affirmance of FERC's policy decision not to recognize the purchase price of a pipeline for any ratemaking purpose except under certain specified circumstances (Pet. 25-29). Its contention, however, raises only the factual issue whether, on the record in this case, it received adequate notice of FERC's intent to decide that issue in Phase I of the agency proceedings. This fact-bound issue does not warrant review by this Court.

In any event, the record amply supports the court of appeals' conclusion (Pet. App. A87 n.78) that Williams was given adequate notice and an opportunity to be heard on the issue. The question whether the purchase price paid by Williams for its facilities should be used for ratemaking purposes has been a sharply contested issue in this case from the beginning. The ICC's ruling on the issue was a major focus of the court of appeals' decision in *Farmers Union I* (584 F.2d at 420-421). Moreover, because of the importance of the issue to Williams' particular rates, Williams addressed the issue from its particular perspective in Phase I of the FERC proceedings. Three of Williams' witnesses discussed the issue of the rate treatment that should be given to the purchase price and, in its brief before FERC, Williams showed how the issue should be handled from its particular perspective (Pet. App. G5-G8). In its decision, FERC adopted a generic rule different from that advocated by Williams and applied that rule to Williams' particular situation (Pet. App. B243). The Commission, however, specified a category of exceptions it would recognize to the general rule (*ibid.*). As the court of appeals noted (Pet. App. A22 n.34), Williams remains free on remand to invoke this exception to the general rule.

In addition, AOPL seeks review of the court of appeals' affirmance (Pet. App. A90-A91) of FERC's decision (Pet. App. B303-

1. Contrary to petitioners' contentions (Williams Pet. 12, 24; Texas Eastern Pet. 7-10; AOPL Pet. 13-24), the court of appeals did not exceed the proper scope of judicial review of agency action. The court correctly noted that the applicable standard was "whether FERC's order * * * was 'arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law'" (Pet. App. A25-A26). The court expressly recognized that it was "not at liberty to substitute [its] own judgment in the place of the agency's" (*id.* at A28), and it scrupulously adhered to that narrow standard of review.

Although the "arbitrary and capricious" standard is highly deferential to the judgment of an administrative agency, this Court has construed the judicial review provisions of 5 U.S.C. 706(2)(A) as requiring a "searching and careful" inquiry into both the facts (*Citizens to Preserve Overton Park, Inc.* v. *Volpe*, 401 U.S. 402, 416 (1971)) and the agency's stated reasons for its decision, to insure that the agency has properly considered the relevant factors in light of its statutory authority. *Motor Vehicle Mfrs. Ass'n* v. *State Farm Mut. Automobile Ins. Co.*, No. 82-354 (June 24, 1983), slip op. 12. In particular, "the courts are the final authorities on issues of statutory construction," and their deference to an agency's interpretation "cannot be allowed to slip into a judicial inertia" or "rubber-stamp[ing]" of agency decisions inconsistent with the legislative intent. *Volkswagenwerk A.G.* v. *FMC*, 390 U.S. 261, 272 (1968).

Guided by these settled principles, the court of appeals acted within the scope of its authority in setting aside

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B304) that deferred taxes may not be included in the rate base for pipeline ratemaking purposes (Pet. 24-30). Whether the deferred tax amounts represent a contribution by the ratepayers, as FERC found, or by the United States Treasury, as AOPL contends (Pet. 26), AOPL has not shown that the affirmance of FERC's exercise of discretion to deny pipeline investors a return on such funds raises a major issue of law or creates a conflict with any other circuit warranting review by this Court.

FERC's decision after concluding that the agency had applied an arbitrary and illogical methodology to achieve purposes not permitted by the Interstate Commerce Act. Thus, this case is wholly unlike *Chevron U.S.A., Inc.* v. *Natural Resources Defense Council, Inc.*, No. 82-1005 (June 25, 1984), on which petitioner Williams relies (Pet. 24). Despite the length of FERC's opinion, there is little evidence that the agency "considered the matter in a detailed and reasoned fashion" (*Chevron*, slip op. 26-27; footnote omitted). This is demonstrated by FERC's statement that the voluminous record compiled before the ALJ was "not * * * especially helpful" and "beside the point" (Pet. App. B207), a statement noted by the court of appeals (*id.* at A44-A45 n.50). In addition, the court expressed the view that FERC had ignored both the legislative history of its governing statute and the court's own mandate in *Farmers Union I* (Pet. App. A29, A37-A42, A51 n.53). In these circumstances, the court concluded that it had no choice but to inquire "into the record in order to assure itself that the agency has examined the relevant data and articulated a reasoned explanation for its action including a 'rational connection between the facts found and the choice made.' *Burlington Truck Lines* v. *United States*, 371 U.S. 156, 168 (1962)" (Pet. App. A27). After conducting its own "searching and careful" review,[9] the court simply could not conclude responsibly, as this Court did in *Chevron*, that the agency's reasoning was "supported by the public record developed in the rulemaking process" (*Chevron*, slip op. 24-25; footnote omitted). Where, as here, the reviewing court's conclusions are based on a thorough review of a lengthy agency record, this Court will intervene only if the lawful standard of review "appears to have been misapprehended or grossly misapplied." *Mobil Oil Corp.* v. *FPC*, 417 U.S. 283, 310 (1974). Such intervention is not warranted in this case.

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[9] See, *e.g.*, Pet. App. A44-A45 n.50, A51 n.54, A52 nn.55-56, A61 n.63, A79-A80.

2. Petitioners' numerous specific challenges to the decision of the court of appeals are without merit.

a. First, the court properly rejected FERC's interpretation of the "just and reasonable" standard under the Interstate Commerce Act. Although the court recognized that " 'no single method' " of arriving at just and reasonable rates " 'need be followed' " (Pet. App. A30, quoting *Wisconsin* v. *FPC*, 373 U.S. 294, 309 (1963)), it found FERC's "novel interpretation of just and reasonable rates" to be "unconvincing" (Pet. App. A30). In so holding, the court focused specifically on the legislative history of the Hepburn Act, rejecting FERC's excessive reliance on "the popular 'climate of opinion' " to determine the meaning of the phrase "just and reasonable" (*id.* at A41-A42).[10] The court held that Congress, which had rejected a proposed "fairly remunerative" standard because it might be construed too generously in favor of the regulated carriers (see *id.* at A38-A39), certainly intended to do more than prevent "extraordinary exploitation or prohibitive pricing practices" (*id.* at A40) by the oil pipelines that it was bringing under regulation for the first time.[11] The court's

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[10] None of the parties had briefed or argued the legislative history of the Hepburn Act at the agency level (see Pet. App. B129-B132). As the basis for its analysis, "FERC primarily examined the works of Ida Tarbell, a progressivist of the turn of the century" (*id.* at A13; see *id.* at B33-B54). The court of appeals focused instead on the floor debates and other legislative materials relating to the Hepburn Act (*id.* at A36-A42). Because the major purpose of the Hepburn Act was to authorize the ICC to prescribe future rates —previously it could only disapprove existing rates—the floor debates were a rich source of relevant material.

[11] Contrary to AOPL's contention (Pet. 16-17), the court of appeals' holding that FERC's legal standard was erroneous (Pet. App. A43-A48) did not rest on a misinterpretation of FERC's decision. FERC was quite clear in stating that its objective was to "set[] ceilings that we assume will seldom be reached in actual practice," because it was convinced that "[f]or oil pipelining * * * regulation * * * should continue to be peripheral to the pricing

interpretation of the statute is consistent with both the common law and the construction of the Interstate Commerce Act prior to the Hepburn Act, and with interpretations of similarly phrased statutes enacted since that time. See, *e.g.*, *Moss* v. *CAB*, 521 F.2d 298, 308 (D.C. Cir. 1975), cert. denied, 424 U.S. 966 (1976).[12]

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process. * * * That peripheral function relates to situations in which monopolistic pockets, short-run disequilibria, or other factors produce market prices that are grossly abusive and socially unacceptable" (*id.* at B283-B284). This approach was central to FERC's decision; it was not mere "rhetoric (and occasional hyperbole)" (AOPL Pet. 15). As the court of appeals concluded, to allow "abusive" rates, so long as they do not become "grossly abusive"—a term FERC never explained—is "by definition" inconsistent with a statute that allows only "just and reasonable" rates (Pet. App. A42, A48). Moreover, as the court pointed out (*id.* at A44), FERC's reliance on market forces to insure reasonable rates was "largely undocumented" and thus could not be sustained under the arbitrary and capricious standard of review.

[12] This Court's decision in *American Paper Inst.* v. *American Elec. Power Serv. Corp.*, No. 82-34 (May 16, 1983), upon which petitioners heavily rely (Williams Pet. 15-16; Texas Eastern Pet. 11; AOPL Pet. 17-18), is irrelevant to this case. The legislative history of the statute at issue in that case stated explicitly that Congress did not intend traditional public utility ratemaking rules to apply to the transactions in question. *American Paper Inst.*, slip op. 11-12. The legislative history of the Hepburn Act, on the other hand, expressly states that oil pipelines are to be considered common carriers; apart from oil pipelines, all other federally regulated common carriers have for some time been subject to regulation under traditional, cost-based ratemaking principles (Pet. App. A41-A42 n.46).

Respondent Phillips Pipe Line Company, in its brief in support of the petitions for certiorari (at 9), contends that the court of appeals' decision in this case is inconsistent with another recent decision of the District of Columbia Circuit in *Wold Communications, Inc.* v. *FCC*, 735 F.2d 1465 (1984). There is no conflict. The court in that case affirmed an FCC ruling partially deregulating some satellite transponder units only after holding that the Communications Act of 1934, 47 U.S.C. 201 *et seq.*, did not require comprehensive regulation of satellite facilities as common carriers. 735 F.2d at 1474-1475 & n.23. The Interstate Commerce Act, on the other hand, does require such regulation of oil pipelines. 49 U.S.C.

This interpretation of the statute does not, as AOPL contends (Pet. 17-18), intrude upon FERC's discretion to maintain a balance between the interests of consumers and investors. FERC had found that the consumer interest in oil pipeline rates was "submicroscopic" at best (Pet. App. B148), and discovered a countervailing and far more important public interest in encouraging new investment in oil pipelines (*id.* at B178-B179). FERC's conclusion that the public interest in effective rate regulation could be ignored merely because oil prices have skyrocketed and "the relative cost of transporting [petroleum products] has fallen" (*id.* at B64) is inconsistent with the legal principles that have guided the formulation of the just and reasonable rate standard.

The statutory terms "just and reasonable" reflect a congressional mandate that shipper and consumer interests are to be protected against the exercise of economic power by the pipelines, and it is not for FERC "to overturn congressional assumptions embedded into the framework of regulation established by the Act." *FPC* v. *Texaco, Inc.*, 417 U.S. 380, 400 (1974). Accord, *National Broiler Marketing Ass'n* v. *United States*, 436 U.S. 816, 827 (1978). Thus, when this Court noted, in the *Trans Alaska Pipeline Rate Cases*, 436 U.S. 631, 653 (1978), that the agency's function is "to strike a fair balance between the needs of the public and the needs of regu-

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(1976 ed.) 1(1)(b). See *The Pipe Line Cases*, 234 U.S. 548 (1914). In any event, this Court does not sit to resolve intracircuit conflicts. See *Wisniewski* v. *United States*, 353 U.S. 901 (1957).

Williams contends (Pet. 8, 17-21) that the court of appeals erred in failing to consider whether the use of a valuation rate base was required by the Valuation Act, 49 U.S.C. (1976 ed.) 19a. The court did consider that issue, however, in *Farmers Union I*; it rejected the contention, and this Court denied certiorari. See note 2, *supra*. In addition, FERC considered the argument on remand and explained that, even if Williams's legal contention were correct, the pipeline industry would secure no practical benefit because the Valuation Act does not require the adoption of any particular formula or weighting of elements (Pet. App. B130 n.209, B185 n.306).

lated carriers," it was not suggesting that the agency has unlimited discretion to redefine the public's interest as insignificant. On the contrary, the agency's function is to determine what constitutes a "reasonable rate of return" or "fair return" to the investor; in doing so it must give the same substantial weight to the public interest in limiting carrier profits that Congress did in enacting the regulatory statute. See *Mobil Oil Corp.* v. *FPC*, 417 U.S. at 301; *Smyth* v. *Ames*, 169 U.S. 466, 547 (1898).

b. In reviewing FERC's exercise of discretion in adopting a valuation methodology, the court of appeals properly recognized that FERC had a duty to explain its deviation from a cost-based methodology, which is the accepted ratemaking methodology in every other federally regulated industry. Petitioners contend that FERC did adequately explain its choice of methodology; they argue that the valuation methodology is especially suited to the lawful consideration of "non-cost" factors (Williams Pet. 14-16; Texas Eastern Pet. 11; AOPL Pet. 14, 21). We disagree. In our view, FERC failed to provide a reasoned justification for its departure from cost-based regulation, a methodology that permits determination of rates that provide both a fair return to the company and protection for consumers.

FERC's retention of the valuation rate base may not be justified on the ground that FERC was merely continuing a "looser" form of regulation (Pet. App. B119) that it inherited from the ICC. The valuation rate base was originally adopted as part of a methodology intended to place effective limits on carrier profits. Its guiding principles were established by this Court's statements in *Smyth* v. *Ames* (169 U.S. at 547) that, in determining reasonableness, the interests of the consumer and regulated entity must both be considered, and that "[w]hat the company is entitled to ask is a fair return upon the value of that which it employs for the public convenience." The Court subsequently defined "fair return" in *Bluefield*

Water Works & Improvement Co. v. *Public Serv. Comm'n*, 262 U.S. 679, 692 (1923), as "equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties." The ICC sought to follow this established legal framework when it adopted its pipeline valuation formula in the early 1940's,[13] by evaluating the risk of pipeline operations and setting allowable rates of return accordingly (Pet. App. A62). The reasons cited by FERC as justifying the "creamy" returns the valuation formula now produces—viz., that oil pipeline ratemaking is not "close work" because the pipelines are entitled to more than a "fair return," that consumer interests may be disregarded,[14] and that comparative risk analysis is

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[13] At the time it was adopted, the valuation methodology was as strict a form of regulation as the ICC legally could adopt under the definition of "fair value" established by *Smyth* v. *Ames*, 169 U.S. at 546-547. For example, in the 1920's the ICC sought to adopt a "net investment base" for railroad regulation, but this Court set aside those decisions for failure to consider reproduction costs as a factor. See *St. Louis & O'Fallon Ry.* v. *United States*, 279 U.S. 461, 484-488 (1929). Since *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944), the ICC has reverted to an original cost rate base for railroads, supplemented by a cash flow analysis. See *Net Investment—Railroad Rate Base & Rates of Return*, 345 I.C.C. 1494, 1519-1520, 1574-1575 (1976). The valuation formula for oil pipelines was already in place by the time *Hope Natural Gas* was decided, however, and was not revisited until this case arose in the 1970's.

[14] Compare *Smyth* v. *Ames*, 169 U.S. at 544: "[T]he rights of the public would be ignored if rates for the transportation of persons or property on a railroad are exacted without reference to the fair value of the property used for the public or the fair value of the services rendered, but in order simply that the corporation may meet operating expenses, pay the interest on its obligations, and declare a dividend to stockholders." See *id.* at 547. It should be noted that the emphasis of the Court in *Smyth* v. *Ames* on the present value or reproduction costs of railroad assets was designed not to give the railroads the benefit of inflation, as FERC seeks to do for the pipelines here, but to reduce the rate bases in light of watered stock and an economic depression. See *id.* at 544-545.

unnecessary—flatly contradict the ICC's legal and policy objectives in adopting the formula in the first place. The continued use of the valuation formula thus masks a fundamental reversal of agency policy, for which this Court's decisions require a reasoned explanation. *Motor Vehicle Mfrs. Ass'n* v. *State Farm Mut. Automobile Ins. Co.*, slip op. 26.

This Court's decision in the *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968), approving consideration of "non-cost" factors under the Natural Gas Act, 15 U.S.C. 717 *et seq.*, supports the court of appeals' holding that FERC must provide a carefully reasoned explanation of any deviations from cost-based ratemaking. As this Court observed in *Mobil Oil Corp.* v. *FPC*, 417 U.S. at 301 (footnote omitted), the Natural Gas Act "was patterned after earlier regulatory statutes that applied to traditional public utilities and transportation companies, and that provided for setting rates equal to such companies' costs of service plus a reasonable rate of return." [15] The Court's holding in *Permian Basin* that the agency's inquiry was not confined to cost (390 U.S. at 791) was firmly conditioned on the requirement that the agency demonstrate a "reasoned consideration" of all pertinent factors, including "the methods by which, and the purposes for which, it has chosen to act," and the consequences of its action for the industry (*id.* at 792). Moreover, the Court stressed, as it did in approving the original cost methodology in *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944), and the "fair value" principle in *Smyth* v. *Ames*, *supra*, that investors' interests are "only one of the variables" to be considered, and that the interests of consumers and the public must also be given weight. *Permian Basin*, 390 U.S. at 769, 791-792. See *Mobil Oil Corp.* v. *FPC*, 417 U.S. at 308-309. Finally, the Court in *Permian Basin* reviewed each of the non-cost factors used and the reason for it, and noted that such factors were

[15] In a footnote, the Court cited the Interstate Commerce Act as an example of the regulatory statutes after which the Natural Gas Act was patterned (417 U.S. at 301 n.22).

being "harnessed side by side" with traditional cost factors, and were not being used as competing bases for decision. 390 U.S. at 814-815.[16]

These cases support the court of appeals' conclusion that FERC's stated reasons for using the valuation methodology are patently inadequate on the record in this case. To the extent that the valuation methodology would result in rates of return on oil pipeline investments that are far higher than would be allowed under the cost-of-capital, comparable-risk analysis of *Bluefield* and *Hope Natural Gas*, the court of appeals correctly found the agency's decision to be contrary to the original purpose of the valuation formula and to the principles of "fair value" rate regulation; this is particularly so in light of FERC's concession that one of its legitimate goals, of avoiding a "front-end load" in pipeline rates, could be accomplished equally well under a cost-based methodology (Pet. App. A62-A64, B227-B228). Likewise, this Court's decisions permitting consideration of "non-cost" factors undermine FERC's theory that it may dismiss consumer interests as "submicroscopic" and entirely forego a cost-based approach in favor of an arbitrary formula that in some unexplained way is supposed to prevent some undefined level of rates that FERC would consider "gross abuse."[17]

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[16] For example, the Court affirmed the FPC's decision that the need to encourage new production justified a distinction between new and old gas, but the maximum price within each category was established by a traditional historical-cost, comparable-risk analysis, albeit on an areawide or national average basis. *Permian Basin*, 390 U.S. at 799-803. Similarly in *FPC* v. *Texaco, Inc., supra*, the Court approved in principle an indirect mode of regulation (417 U.S. at 387), but reversed the FPC's decision to the extent that the agency failed to assure effective adherence to the statutory standard of reasonableness (*id.* at 394-401).

[17] The retention of a valuation rate base requires explanation in itself because, as FERC found, "the language of American finance is an original cost language" (Pet. App. B189). Earnings of firms that might be used to determine comparable rates of return are

c. The court of appeals concluded that FERC's rate of return methodology was unlawful because it ignored the need for a comparative risk analysis, it allowed a double recovery for inflation, and it defined the equity rate base in a way that arbitrarily inflated allowable returns (Pet. App. A73-A86). In challenging this conclusion, AOPL mischaracterizes both the record and the court of appeals' opinion.

Initially, AOPL asserts (Pet. 22-23) that "FERC's decision does not reject the comparable risk/comparable earnings standard for rate of return determinations," but rejects only the "particular methodology" used in "public utility regulation." This statement ignores both FERC's own explanation that "risk analysis does not advance [its] inquiry" (Pet. App. B205 n.340) because a rate of return keyed to the relative risk of pipeline operations might not be enough to generate oil company investment in pipelines, and FERC's related conclusion that pipeline investment can be assured only if the oil companies are permitted to earn as much from pipelines as they could from any other potential investment, no matter how much riskier the alternatives might be (*id.* at B202-B212). It also ignores the fact that FERC's selection of eight categories of "roughly comparable" unregulated firms (*id.* at B274-B276) was not based on risk analysis of any kind. Indeed, the court of appeals could find no support for use of these categories beyond FERC's "blind, con-

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published as returns on "net investment," not current value (*id.* at B188). Similarly, when oil company managers consider whether to invest in a pipeline, they project its potential earnings or "discounted cash flow" on an original cost basis (VI C.A. App. 3339, 3354, 3452, 3470-3473; VII C.A. App. 3539, 3591). Thus, as a practical matter, cost-based methodologies allow regulators to determine whether regulated returns are "commensurate with returns on investments in other enterprises having corresponding risks" (*FPC* v. *Hope Natural Gas Co.*, 320 U.S. at 603), while the arbitrary relationship between a valuation rate base and original cost renders the ICC methodology useless as a measure of comparable earnings for either regulators or investors.

clusionary assertion of 'rough comparability'" (*id.* at A77).

AOPL also asserts (Pet. 23) that the court of appeals rejected FERC's rate of return methodology in part because increases in the valuation rate base do not "track inflation." On the contrary, the court explicitly recognized that it was not necessary to achieve a precise match between inflation and valuation increases, so long as the rate of return is properly adjusted (Pet. App. A80). Instead, its concern was with the potential for year-to-year manipulation of the multiple time period choices for computing comparable rates of return that the Commission gave the pipelines, and FERC's failure to provide any rational explanation or support in the record for such a system (*id.* at A80-A81). As the court noted, FERC's method "'invites an enormous amount of gamesmanship'" (*id.* at A81) because it allows a pipeline to "compensate" for the inflation adjustment in the rate base by matching a period of relatively low rate base appreciation with the highest "market" rate of return it could find for that period, and to switch rate of return indices from year to year to benefit from the best match available.[18] FERC has not "advanced a reasonable explanation" (*Chevron*, slip op. 24) for its use of an inflation adjustment that is so capable of manipulation.

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[18] The FERC methodology applies to the rate base a "market" rate of return, decreased by the appreciation in the rate base in the period corresponding to the "market" return selected. So, for example, if the market return selected were "[r]ealized nominal rates of return * * * in the oil industry generally over the past year" (Pet. App. A74), the corresponding deduction from that rate of return would be the percentage appreciation in the rate base over the past year. Since the FERC methodology offers pipelines both different nominal rate of return indices and different time periods over which to measure these returns (*id.* at A74-A75), the methodology invites a pipeline to "shop around" for the index and time period which give it the greatest market rate of return and yet require it to subtract the lowest deduction for rate base appreciation.

Finally, AOPL argues (Pet. 23-24) that FERC did not allow double recovery for inflation by allowing equity holders a return on the write-up of that portion of the rate base originally attributable to debt. This argument is without merit. The problem arises from the fact that the marketplace returns that FERC necessarily uses for comparables are all based on original cost. FERC erred in failing to recognize that the reported returns on original cost in the "unregulated competitive sector" that it seeks to use as a model (Pet. App. B283) are adjusted for the "leverage," or debt component, of the reporting firms.[19] Thus FERC could have achieved a fair result only if it had limited the equity holders to a return on their *pro rata* share of the appreciated rate base, without an "equity kicker" (*id.* at B282). The court of appeals correctly criticized FERC's methodology for arbitrarily allowing rates of return on pipeline investments that are much higher than those earned in the industries that FERC had selected for comparison (*id.* at A81-A84). In short, "the combination of FERC's rate base and rate of return methodologies does not produce an acceptable 'end result' " (*id.* at A86), and the court of appeals properly refused to sustain it.

3. Petitioners' suggestions that the court of appeals' decision will undermine the nation's economy by drying up investment in oil pipelines (Williams Pet. 7; Texas Eastern Pet. 15; AOPL Pet. 10-11) are supported neither by evidence nor by logic. Even if the court's decision ultimately induces FERC to abandon a valuation methodology, it still sets no inherent limits on a pipeline's ability to earn a reasonable and adequate rate of return. As this

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[19] Consider, for example, a firm that is capitalized at $1,000, of which $500 is debt at 10% interest; if such a firm earns $200, the debt holders receive only $50 and the equity holders $150. This results in a nominal rate of return of 30%, since it is computed on the original equity investment. If the entire capitalization had been equity, the shareholder would have received a return of only 20%, so the effect of leverage is reflected in higher current returns as compensation for "financial risk" (III C.A. App. 1435-1437).

Court explained in *FPC* v. *Hope Natural Gas Co.*, 320 U.S. at 603, under a cost-based methodology, the return allowed, while considering consumer interests, "should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." In addition, the court of appeals explicitly acknowledged that the need to stimulate new supplies through investment is a non-cost factor that FERC properly may consider in setting rates for oil pipelines, provided, of course, that this factor is adequately explained and justified (Pet. App. A34-A35, A92). Thus, the court of appeals has clearly mapped the path for prompt action by FERC to alleviate petitioners' concerns about the attractiveness of future pipeline investment.

In sum, in remanding this case to the Commission, the court of appeals left ample room for the exercise of agency discretion in fashioning a proper ratemaking methodology. Further review, if any, should await the Commission's efforts on remand to correct the errors identified by the court of appeals and develop a rational methodology for regulating oil pipeline rates.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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